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SUBJECT: INTERAGENCY INSIGHTS FROM NDRC FINANCE DIRECTOR  
GENERAL

Classified By: Minister-Counselor for Economic Affairs Robert Luke; Rea  
sons: 1.4 (B/D)

SUMMARY

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11. (S) The recently-promoted National Development Reform Commission (NDRC) Director General in charge of financial affairs (protect) offered candid and even critical comments about the Ministry of Finance (MOF), the People's Bank of China (PBOC), and the internal workings of the NDRC itself. He faulted MOF for excessive focus on the accounting of government financial flows without thinking more broadly about the effect of changes in fiscal policy on the economy. He criticized the PBOC for being too lenient in its approval of corporate bond issuances. The DG spoke highly of the NDRC itself, describing an informal atmosphere with strenuous internal debates, and noted that its influence draws mainly from its role as the secretariat to the State Council on economic policy. He faulted his superiors, however, for a lack of understanding about the necessary prerequisites for developing a corporate bond market. The DG is a former Humphrey Fellow and spoke warmly of the opportunity provided to him a decade ago to study in the United States. END  
SUMMARY.

UNUSUAL CANDOR

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12. (S) Our NDRC contacts are generally tight-lipped and stick to their talking points, but on September 28, a newly-promoted DG broke this mold during a gathering with Econ MinCouns, Finatt, and Econoff. DG Xu Lin (protect) oversees the Department of Fiscal and Financial Affairs and was recently a Deputy DG involved with the formulation of the Eleventh Five-Year Plan. He spoke with notable frankness about the challenges of coordinating economic and financial policy with other agencies in the Chinese Government and even within the NDRC itself.

AT ODDS WITH HIGHER-UPS ON CORPORATE BONDS

13. (S) Xu said that most of his time is devoted to overseeing China's (corporate) bond market. Xu lauded progress to date, noting that market capitalization recently jumped to around USD 13 billion (RMB 100 billion) from USD 8 billion (RMB 65 billion) a year ago. Xu noted an important goal of his is to increase access to the bond market for small and private sector firms. (Comment: Almost all long-term bond issuances are by large state-owned enterprises. End Comment.)

14. (S) Xu stressed, however, the need to proceed cautiously, noting that moral hazard among borrowers is a bigger risk in the bond market than in the banking sector, despite the large number of non-performing loans in the latter. When asked, he gave no indication that the requirement that all bond issuances be guaranteed by banks (a key factor for borrower moral hazard) would be lifted soon. Xu stressed that Chinese investors are not adept at assessing and pricing credit risks.

15. (S) When asked about NDRC's recent decision to postpone large foreign currency denominated bond issuances by MOF, China Ex-Im Bank, and China Development Bank, Xu complained that his bosses at NDRC view bond issuances primarily as a way to finance investment and manage overheating. In Xu's view, his bosses should better appreciate the importance of sovereign issues in establishing a liquid benchmark yield curve that can be used to price corporate risk, even if the bonds are not needed for financing.

16. (S) Xu criticized the PBOC as being too lenient in its approval of bond issuances. (Comment: PBOC regulates the inter-bank short-term bond market, while NDRC regulates the long-term bond market. End Comment.) NDRC not only pays greater attention to borrowers, creditworthiness, but bases

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its approval on the extent to which the proposed financing promotes China's industrial policy goals. Xu said that prior to his arrival, the NDRC and PBOC clashed over this issue, with the disagreement reaching the extent that NDRC would not consider approving a bond issuance by any company which had used the short-term bond market. Xu said he has tried to patch things up since that time and has reversed this policy.

17. (C) Comment: When China's corporations raise funds, they overwhelmingly rely on bank loans. Corporate bonds provide an alternative capital market-based means for taking on debt, and establishing broad trade in a liquid set of trading instruments of this sort is considered a hallmark of financial system liberalization and development. In China, however, corporate bonds lag far behind stocks and government bonds as a capital market fund raising tool, mainly because financial regulators have been concerned about the impact of financial disintermediation on the health of China's large state-owned commercial banks and NDRC's desire to channel financing to favored sectors, firms, and projects. (Xu admitted, for example, that sectors considered to have excessive investment, such as steel, autos, and even basic infrastructure, are not looked upon favorably for bond issuance.) To date, corporate bonds have generally been associated with specific construction projects. EIU statistics show that as of June 2006, there were 53 financial and corporate bond issuances traded in Shanghai with a market capitalization of approximately USD 15 billion (RMB 118 billion). End Comment.

CRITICAL OF MOF APPROACH TO FISCAL POLICY

18. (S) Xu was critical of MOF for focusing excessively on accounting for government revenues and expenditures rather than thinking about the dynamic economic effects of changes in fiscal policy, especially on a sectoral basis. Finatt noted the view of many economists that rebalancing the

macroeconomic policy mix though tighter monetary policy and looser fiscal policy (particularly through increased social safety net expenditures) would help China achieve more balanced, consumption-led growth. Xu acknowledged the need to increase social welfare expenditures but suggested that, given signs of overheating, the government should tighten both monetary and fiscal policies, i.e., government policies should be a net catalyst for reining in the economy.

#### CURRENCY THOUGHTS

¶9. (S) Xu said that when China adjusted its exchange rate in July 2005, he was concerned that the 2.1% appreciation was too modest. His view at the time was that a larger movement was in order so as to create a market perception of two-way appreciation/depreciation risk in order to limit speculative inflows. Xu did not elaborate to what degree he may have revised this view, but said he supports continuation of the RMB's gradual appreciation. Xu observed that NDRC has only one seat on the PBOC Monetary Policy Committee, occupied by NDRC Deputy Chairman Zhu Zhixin, but stressed that that NDRC's greater influence comes through its role of preparing policy documents for the State Council. Xu noted that he and his staff advise Zhu on monetary and exchange rate matters.

#### BOHAI EQUITY FUND

¶10. (C) Xu trumpeted the creation of China's first "private equity" fund, the Bohai Industrial Investment Fund, which will be based in Tianjin and directed by a former employee of the Bank of China in Hong Kong. While acknowledging that the fund will actually be composed of government money, Xu said that the creation of such funds is an important component of financial liberalization and could boost other alternative financing means like venture capital. Recent Chinese and Western media reports covered National Social Security Fund (NSSF) Chairman Xiang Huaicheng announcing the fund on September 20 at the Sino-French Financial Forum in Beijing.

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The NSSF, which has amassed nearly USD 29 billion, will put approximately USD 130 million (RMB 1 billion) into the Bohai fund.

#### NDRC'S INTERNAL CULTURE

¶11. (S) Xu described interaction at the NDRC as informal and collegial, with people from different sections routinely engaged in vigorous internal debate. Xu's own section has 19 people, and their work is often informed by the work of sector-focused analysts in other departments.

#### BIOGRAPHICAL INFORMATION

¶12. (C) Xu speaks excellent English and appears favorably disposed towards the United States, particularly as a result of studying from 1995-96 at American University as a Humphrey Fellow. Xu was promoted in June 2006 to his current position. Xu would be an excellent interlocutor for visiting USG finance and economic officials and a useful participant in bilaterals covering financial sector issues, such as the U.S.-China Financial Sector Working Group. (Finatt invited him to the next session scheduled in January 2007.)

¶13. (U) Highlights taken from Xu's biography previously provided to the Boao Forum:

Born: June 12, 1962; Changsha, Hunan Province.

#### Experience and Activities:

-- Deputy Division Director, Division Director, and Deputy Director General in the Department of Development and

Planning at the NDRC.

-- According to the Bohai bio, Xu "was in charge of formulating (the) national five-year development plan, industrial policies, regional development policies, and trade policies, (and) has been involved in formulating China's eighth five-year, ninth five-year, and tenth five-year social and economic development plans."

-- Member of the Chinese WTO delegation, in charge of the negotiation on industrial policies and industrial subsidies.

Education:

-- June 1995-July 1996, Hubert Humphrey Fellow at the American University (Washington DC)

-- 1989, M.A. in Economics, Institute of Economics, Nankai University (Tianjin)

-- 1981, B.A., Department of Mathematics, Shaoyang College (Hunan)

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